

MARKET OUTLOOK

June 2009

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Where to now?

The global economy continues to show signs of healing, raising hopes that the turning point may be in sight. But fragile financial conditions, significant further balance sheet retrenchment and the widespread plunge in activity and credit availability remain a drag on global trade. This suggests that while markets may continue to improve, aiding financial conditions and restoring confidence, gains are likely to be more muted and more diverse.

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Feature

Where to now?

Signs of stabilisation multiply, but healing is a slow process

The global economy continues to show signs of healing, raising hopes that the turning point may be in sight. Though many high frequency indicators are still consistent with recession in both developed and emerging market economies, including purchasing manager indices, exports, and industrial production, the pace of contraction has generally slowed, with some instances of outright expansion. More importantly, financial markets have shown continued improvement over the last couple of weeks. Bond spreads and credit default swaps have also narrowed back to levels last seen before the Lehman Brothers failure, whilst measures of bank liquidity appear to have normalised.

These developments in the real economy and financial markets are a welcome change from the wrenching turbulence of the past seven or eight months and have raised confidence that the US economy and much of the emerging world will bottom later this year, with Europe and Japan rebounding next year. Still, the pace of recovery is expected to be subdued, more likely taking the form of a U-shaped rather than a V-shaped recovery. Indeed, fragile financial conditions, significant further balance sheet retrenchment and the widespread plunge in activity and credit availability remain a drag on global trade. This suggests that while markets may continue to improve, aiding financial conditions and restoring confidence, gains are likely to be more muted and more diverse.

Risk is back

Historically, high risk assets have outperformed low risk assets significantly after equity markets have bottomed. Although the fundamental backdrop is still difficult, Citi analysts think that the March low likely signalled the trough in this equity bear market. Risk assets have rallied strongly since global equity markets hit their recent lows in early March. Global equities have led the way, rising by 35%¹ and a 640 bps collapse in spreads has seen US high yield return 25%¹. Equities, commodities and high yield credit have outperformed cash and government bonds by a wide margin, while lower risk investment grade returns have been poor by comparison.

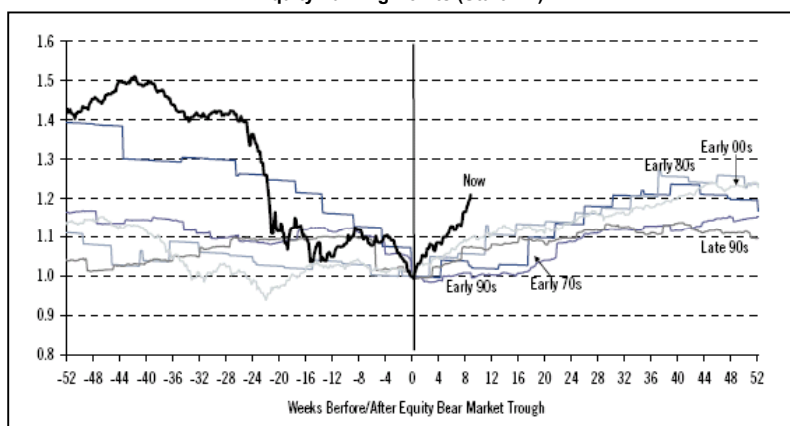
The risk trade also looks to have made a comeback within equity markets. At a global sector level, Citi analysts observed that there has been a dramatic rotation away from defensives into cyclicals. On average, defensives have underperformed the overall market by just under 20%¹. Risk outperformance has also been seen at the market cap level, with global small and mid cap performance comfortably ahead of that of large cap.

Still room for rally to continue, but consolidation likely ahead

Citi analysts however caution that the recent rebound in risk assets represents the fastest ever recovery from a global equity market low. The outperformance relative to defensive assets of over 20% is far greater than that seen before at such an early stage in previous recoveries and only slightly behind the best relative returns that have occurred in the full twelve months after equity bear market troughs.

Previous experiences as such, suggest that we may be due for a period of consolidation. Nonetheless, Citi analysts continue to believe that there remains scope for the current rally to continue, although its magnitude so far suggests that upside is probably limited from here. At the same time, investors looking for the chance to get in at dramatically lower levels could be disappointed as pullbacks in the early stages of equity market recoveries tend to be both short lived and small in magnitude. In the near term, investors seeking to reduce risk may wish to consider rotating some profits from higher risk assets into lower risk investments. Looking further out, Citi analysts believe any weakness over the summer or a continuing improvement in the fundamental backdrop should be viewed as buying opportunities to increase risk exposure, with preference to equities.

Chart 1: Relative Performance of High Risk vs. Low Risk Around Equity Turning Points (Start = 1)

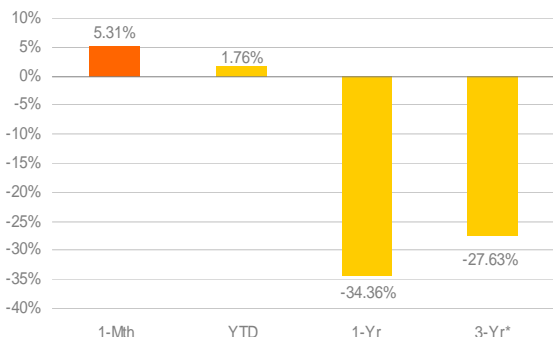


Source: CIRA, DataStream. As of 13 May 2009
High Risk = Equities, Inv Grade and HY bonds, Low Risk = Govt bonds and cash.
Vertical lines denote equity bear market troughs

1. Performance from 9 March 2009 – 8 May 2009

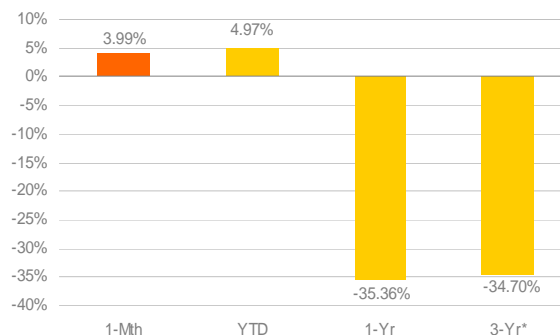
Equity markets

Chart 2:
S&P 500 Index



*Denotes cumulative performance
Performance data as of 29 May 2009
Source: Bloomberg

Chart 3:
Dow Jones Stoxx 600 Index



*Denotes cumulative performance
Performance data as of 29 May 2009
Source: Bloomberg

United States

Recession appears to be losing its intensity

- Several developments suggest the recession is losing its intensity. Indeed, massive production cuts have pared inventories more in line with subdued spending, while construction and sales of homes show signs of steadying. Furthermore, fiscal supports will likely blunt some of the impact of declining investment and belt tightening among state and local governments.
- However, Citi analysts note that the economy is still constrained by the lagged effects of steep wealth losses and rising joblessness. While confidence is slowly returning, savings rates are likely to edge higher this year.
- The Federal Reserve's ongoing attempts at accommodation through credit-support operations have helped to buoy financial conditions. But the financial landscape is not nearly supportive enough and risk appetites still appear fragile. As such, Citi's baseline does not foresee an unwinding of accommodation over the two-year forecast horizon.
- Although Citi analysts recognise that the market may need to settle down a bit after extraordinary returns seen over the past two months, they believe that gains are still likely over the next six or so months on the back of attractive valuations and subsiding volatility.
- Within sectors, Citi analysts are reducing their weighting on Retail stocks to neutral from overweight as the sector has surged more than 20% so far this year and outperformed over the past 12 months. At the same time, the Telecom Services sector has been downgraded to underweight from neutral, given peak-like earnings revisions.

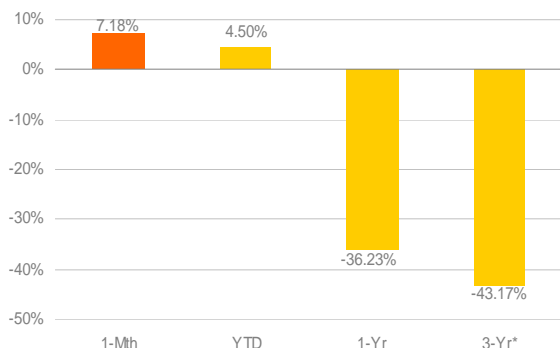
Euro-Area

Inflation could remain low for a prolonged period of time

- While there is almost no evidence of a near-term end to the deep recession in the euro area, the recent improvement in sentiment indicators and the stabilization in some real activity indicators suggest that the pace of gross domestic product (GDP) contraction is likely to slow in the second quarter.
- Meanwhile, the already record-low capacity utilization and the likely further widening of the negative output gap to around 6% in 2010 suggests that euro area inflation may remain low for a prolonged period of time and that risks of deflation are not negligible.
- After lowering interest rates to 1% in May, Citi analysts think the European Central Bank (ECB) may adopt a wait-and-see approach. Instead, they are likely to implement the already approved expansion of the open market facilities to 12 months and the €60 billion covered bond purchases.
- Citi analysts suspect that March 2009 likely marked the lows for equity markets in the current cycle. From the highs in summer 2007, UK and European equities have recorded a 60% fall. In their view, this bear market rally could translate into the start of a bull market, provided the prospect of deflation and further economic disintegration does not return.
- Nevertheless, Citi analysts are sticking to their core view: 1) Positive on equities, 2) Quality risk assets are cheap, 3) The recovery trade is not yet priced in, and 4) Clear winners and losers may emerge within industry groups. Within sectors, Citi analysts are overweight defensive sectors such as Health Care and Telecoms while underweight Industrials and Utilities.

Equity markets

Chart 4:
Topix Index



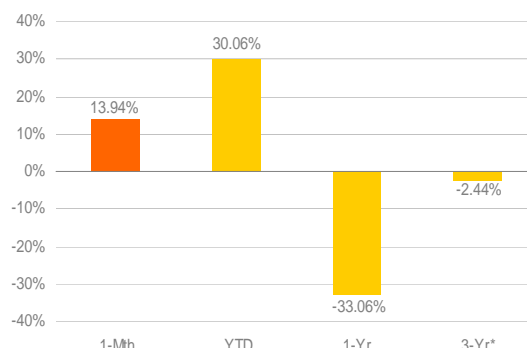
*Denotes cumulative performance
Performance data as of 29 May 2009
Source: Bloomberg

Japan

Economy may show renewed weakness in 1H10

- Economic data over the past month revealed more compelling signs of stabilization in economic activity: industrial production rose for the first time since September 2008, and exports stopped declining in part supported by a pickup in trade with China.
- However, prospects for private domestic demand remain bleak. Deterioration in corporate profits, along with declines in operating rates, are likely to depress business investment in coming quarters. Moreover, worsening labour/income conditions may take a toll on consumer spending and housing investment. As a result, Citi analysts expect the economy to show renewed weakness in the first half of 2010, as the effect of the economic stimulus package wanes and as the recovery in foreign economies generally remain lacklustre.
- The main focus of monetary policy has shifted to supporting dysfunctional financial intermediation by purchasing commercial papers and corporate bonds, providing longer-term funding to banks, and relaxing banks' balance sheet constraints. Given that economic growth may exceed trend growth in coming quarters, however, the Bank of Japan appears unlikely to take proactive steps including increases of outright long-term JGB purchases over the near term.
- According to Citi analysts, foreign buyers may send stocks up more than expected in 2H09 given loose monetary policy. But pork-barrel fiscal packages have never been a recipe for a long-term rise in share prices and Citi analysts expect the rally to be short-lived.
- Within sectors, Citi analysts are overweight exporters and underweight defensives. Among domestic-demand stocks, they have a negative view on paper and pulp, retail, and services. Among defensives, they favour those with growth potential in Asia.

Chart 5:
MSCI Asia ex Japan Index



*Denotes cumulative performance
Performance data as of 29 May 2009
Source: Bloomberg

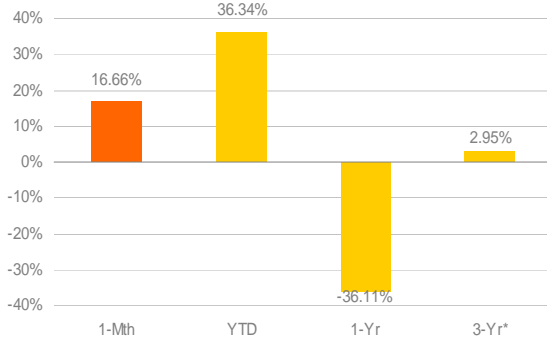
Asia Pacific

Asian currencies likely to appreciate in the long term

- While relative growth optimism about the region is valid (strong fiscal, bank and household balance sheets appear supportive), lingering risks need to be factored in. Indeed, a sub-par recovery path in the US and Europe on top of still significant inventory overhang would stall re-stocking momentum, and China's investment-driven growth engine could worsen excess capacity.
- Central banks in Thailand, China, Korea, Taiwan and Malaysia look to have ended their interest rate easing cycle. While Citi analysts are not expecting any policy tightening in the foreseeable future, they believe that market expectations of policy tightening could potentially build earlier in China and Korea.
- While Asian currencies appear vulnerable to a near-term pull-back after a sustained run, Citi analysts expect the longer-term appreciation story to remain intact on external flows, further anchored by the Chinese Yuan's (CNY) growing undervaluation as the US dollar weakens. In particular, they remain positive on the Korean Won (KRW), Indonesian Rupiah (IDR) and Malaysian Ringgit (MYR).
- According to Citi, dividend yield investing has generally outperformed out of recessions and in sideways markets, which are the two most likely scenarios now. The only time it does not do so well is at the end of a bull market. Thus, Citi analysts believe that in the current situation, yield may again outperform as in the past.
- Against this backdrop, Citi analysts continue to favour sectors that display strong cashflow and dividend yield. Hence, Citi analysts remain positive on Banks, Telecoms and Tech sectors, prefer large-caps to small and mid-caps, and North Asia to China, India and Southeast Asia.

Bond markets

Chart 6:
MSCI Emerging Markets Index



*Denotes cumulative performance
Performance data as of 29 May 2009
Source: Bloomberg

Emerging Markets

Third phase of global crisis likely to pose fewer risks

- Emerging economies appear to have passed through two phases of the global crisis: Financial Vulnerability Phase and External Vulnerability Phase, and are now entering a third: Fiscal Vulnerability Phase.
- Thanks to budget discipline in many countries during the past few years, Citi analysts believe that this third phase may pose fewer risks. In their opinion, countries most at risk here are likely to be ones with unrealistic budget assumptions and high debt to GDP ratios.
- In Latin American, Citi analysts expect improving external accounts, early signs of a global economic recovery, and carry trades to support the Brazilian Real (BRL) and Colombian Peso (COP). Over in CEEMEA¹, they expect the Russian Ruble (RUB) to appreciate in the short term given rising oil prices but anticipate Polish Zloty (PLN) weakness as the deeper-than-expected economic slowdown weakens fiscal revenues.
- Given that global macro and equity market fundamentals look much more positive than they did 2-3 months ago, Citi analysts are cutting their defensive strategy in Latin America. Instead they are now overweight Brazil and Peru. In terms of sector, they favour materials, technology and consumer staples.
- CEEMEA has come through the crises of recent times with their fundamentals in better shape than in previous cycles. However, Citi analysts remain cautious in the near-term as valuations are no longer as compelling. Citi analysts are overweight on Russia, Turkey, Czech Republic and Egypt; neutral on Israel and Poland; and underweight on South Africa and Hungary.

1. CEEMEA is the collective term for Central and Eastern Europe, Middle East and Africa.

Favour high-grade corporate bonds

US Treasuries

Citi analysts remain underweight US treasuries, as historically low interest rates offer investors with little opportunity for significant returns.

US Corporates

Despite the rally in the corporate bond market, spreads are still attractive on a historical basis. This segment continues to be Citi's preferred investment for 2009. On the other hand, they are cautious on high yield bonds as spreads have come too far too fast. For investors seeking exposure, Citi analysts prefer the shorter end of the curve (1-3 years), given that longer durations provide minimal yield pickup for increased risk.

Euro Bonds

Weak economic fundamentals as well as declining inflation could push bond yields lower and prices higher. Citi analysts expect a steepening of the Euro zone government bond market, with yields in the short end of the curve falling more than yields in the long end.

Emerging Market Debt

Citi analysts remain cautious on emerging-market bonds as they may face further volatility in coming months. For investors seeking exposure, Citi analysts prefer countries with sound economic fundamentals and minimal political risk.

General Disclosure

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Investment Insights

About: Equity-Linked Notes (ELNs)

What are Equity-Linked Notes (ELNs)? How can they be used?

An Equity-Linked Note is a structured note linked to a share. A typical ELN is purchased at 100% price of the Nominal Amount and offers investors an enhanced yield in a Fixed Coupon amount at Maturity. On the Maturity Date, depending on where the Final Share Price of the Share is at, above or below the Strike Price, the investor would receive a Redemption Amount in the form of either cash or physical delivery of the Share (valued at a predetermined Strike Price). Investors can use ELNs to attempt to enhance yield in a portfolio relative to deposit rates or use ELNs to attempt to identify entry points into targeted stocks below the current market price.

What are some of the key risks associated with ELNs?

Price: Stock price fluctuates, investors therefore hold the risk of the stock price going below the strike price and the ELN is converted

Liquidity: Secondary market is typically illiquid – Before maturity, bid prices may be available only on a selective basis and are likely to be unattractive

Issuer: Investors are exposed to the risk that the issuer becomes insolvent

Potential Capital Loss: Not from the ELN but from the stock in the event of exercise

How do they work?

On the Maturity Date, one of the following two scenarios would result:

- (1) If the Final Share Price of the Share equals to or is greater than the predetermined Strike, investors will receive the 100% of the Denomination per Note in cash; **or**
- (2) If the Final Share Price of the Share is less than the pre-determined Strike, investors will receive physical delivery of the Share. The number of physical shares the investors receive per Note will equal to the Denomination per Note divided by the predetermined Strike rounded down to the nearest whole number of the share, as determined by the Calculation Agent. Fractional shares may result in delivery of cash in addition to the shares at the issuer's option. Investors will be responsible for any stamp duty and fees on the share transfer in relation to the delivery of shares by the issuer.

Hypothetical example:

Tenor of Note: 32 Days

Denomination Per Note: US\$10,000

Number of Notes: 1

Fixed Coupon: US\$100 (1% or 11.41% p.a.)

Initial Share Price: US\$50.00

Strike Price: US\$45.00 (90% of Initial Share Price)

Underlying Stock Price on Final Valuation	Investor Receives	Note Value + Coupon (US\$)	Mark-to-Market Gain/(Loss) (US\$)	Annualized Return on the ELN	Gross Loss on the ELN
70	Cash	10,100.00	100.00	11.41%	N/A
65	Cash	10,100.00	100.00	11.41%	N/A
60	Cash	10,100.00	100.00	11.41%	N/A
50 (Initial Spot Price)	Cash	10,100.00	100.00	11.41%	N/A
45 (Strike Price)	Cash	10,100.00	100.00	11.41%	N/A
44.7	Cash + Stock	10,033.33	33.33	3.80%	N/A
44.55 (Breakeven Price)	Cash + Stock	10,000.00	0.00	0%	N/A
44	Cash + Stock	9,877.78	-122.22	N/A	-1.22%
43	Cash + Stock	9,655.56	-344.44	N/A	-3.44%
42	Cash + Stock	9,433.33	-566.67	N/A	-5.67%
41	Cash + Stock	9,211.11	-788.89	N/A	-7.89%
40	Cash + Stock	8,988.89	-1,011.11	N/A	-10.11%

Scenario 3: Breakeven price of the Share

Redemption by physical delivery of the SHARE and FIXED COUPON

Denomination per Note = US\$10,000 (in cash)

Fixed Coupon = (1% * US\$10,000) = US\$100

Redemption by way of physical delivery of Share per Note = (Denomination per Note / Strike Price) = (US\$10,000/US\$45.00) = 222 Shares (rounded down to the nearest whole number)

Fractional cash amount = Final Share Price x The Fractional Amount = US\$44.55 x 0.222 = US\$9.90 (rounded to the nearest 2 decimal places with 0.005 or more rounded upwards)

Return per note: If investor decides to sell the Share at market price (e.g. US\$44.55) immediately, = Proceeds from selling the Shares + Fixed Coupon + Fractional cash amount – Denomination per Note

= (US\$44.55 x 222) + US\$100 + US\$9.90 - US\$10,000 = US\$0.0 (Return).

In this scenario, the investor has reached the break-even point whereby he will not make neither a profit nor a loss through his investment.

Scenario 4: Closing Share Price on Final Valuation Date < Strike

Redemption by physical delivery of the SHARE and FIXED COUPON

Denomination per Note = US\$10,000 (in cash)

Fixed Coupon = (1% * US\$10,000) = US\$100

Redemption by way of physical delivery of Share per Note = (US\$10,000/US\$45.00) = 222 Shares (rounded down to the nearest whole number)

Fractional cash amount = Final Share Price x The Fractional Amount = US\$42.00 x 0.222 = US\$9.33 (rounded to the nearest 2 decimal places with 0.005 or more rounded upwards)

Return per note: If investor decides to sell the Share at market price (e.g. US\$42.00) immediately, = Proceeds from selling the Shares + Fixed Coupon + Fractional cash amount – Denomination per Note = (US\$42.00 x 222) + US\$100 + US\$9.33 - US\$10,000 = -US\$566.67 (loss).

Total Loss = -US\$566.67 / US\$10,000 = -5.67% (rounded to 2 decimal place)

In this scenario, the unrealized loss (or realized loss should the investor sell the Underlying at the market price) to the investor would be -US\$567.00.

Scenario 1: Worst Case Scenario

Investors may lose all their initial investment in the event of:

- Issuer default; or
- If the Closing Share Price is zero on the Final Valuation Date.

Scenario 2: Closing Share Price on Final Valuation Date ≥ Strike

Redemption in CASH and FIXED COUPON

Denomination per Note = US\$10,000 (in cash)

i.e. 100% Denomination per Note + 1% Fixed Coupon = (100% + 1%) * US\$10,000 = US\$10,100

Return: (Redemption Amt – Initial Invested Amt) = (US\$10,100 - US\$10,000) = US\$100

Annualized Yield to Maturity = [(US\$100/ US\$10,000) / 32] x 365 = 11.41% (rounded to 2 decimal place)

Source: Citibank N.A., Singapore Branch, Regional Wealth Management.

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